MCI Communications Corporation

MCI

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April 8, 1999

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
TW-A325
445 12th Street, S.W.
Washington, D.C. 20554

Re: **CC Docket No. 98-166; Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, Notice of Proposed Rulemaking**

Dear Ms. Salas:

Enclosed herewith for filing are the original and four (4) copies of MCI WorldCom, Inc.'s Rebuttal Submission in the above-captioned proceeding.

Please acknowledge receipt by affixing an appropriate notation on the copy of the Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Chris Frentrup

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MCI WorldCom, Inc.

Enclosure

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Prescribing the Authorized	)	**CC Docket No. 98-166**
Unitary Rate of Return for	)	
Interstate Services of	)	
Local Exchange Carriers	)	

REBUTTAL SUBMISSION OF MCI WORLDCOM, INC.

APRIL 8, 1999

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SUMMARY

The Reply Comments of the incumbent local exchange carriers (ILECs) seek to convince the Commission that the cost of capital for telephone companies has increased, when all objective evidence demonstrates the contrary. The ILECs' claimed increase is merely the result of improperly performed Discounted Cash Flow (DCF) studies and the use of a capital structure containing excessive equity. In particular, the ILECs have no convincing argument for substituting a broad group of industrial companies, which have little or no telephone operations, for the regional Bell Operating Companies (RBOCs), whose assets are predominantly devoted to local exchange service, as the proxy group for use in a DCF study. The cost of equity results obtained using the industrial proxy groups (about 15 percent) is implausibly high.

MCI WorldCom continues to support a represcription of rate of return in this proceeding. Capital structure should be based upon the use of ARMIS balance sheet data, as proposed in the Notice, and cost of equity should be computed using the classic DCF applied to the RBOC proxy group.

Finally, MCI WorldCom reiterates its position that if the low end formula adjustment mechanism (LFAM) is retained for the price cap companies, the return benchmark that triggers the LFAM must be lowered to reflect the rate of return represcription in this proceeding.

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REBUTTAL SUBMISSION OF
MCI WORLDCOM, INC.

I. INTRODUCTION

On October 5, 1998, this Commission released a Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking ("Notice")[1] proposing to conduct a proceeding to represcribe the rate of return for the incumbent local exchange carriers (ILECs) that are subject to rate of return regulation for interstate services. In response to this Notice, a number of parties submitted Initial Comments and Direct Cases on January 19, 1999. Parties representing the ILECs argued that the authorized rate of return should not be lowered, due to increases in business risk associated with providing access services and the need for a higher equity ratio. They further opposed any modifications at this time in the "low end formula adjustment mechanism" (LFAM) associated with the price cap

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1 Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 98-166, Notice Initiating a Prescription Proceeding and Notice of Proposed Rulemaking, FCC 98-222, (released October 5, 1998) ("Notice").

plan. One party, the General Services Administration (GSA), presented cost of equity evidence demonstrating that the currently authorized return of 11.25 percent greatly overstates the present ILEC cost of capital.

The parties submitted Reply Comments on March 16, 1999 in response to the Initial Comments. The Reply Comments presented far more technical information than provided in the Initial Comments, with ILEC parties sponsoring cost of capital studies prepared by Dr. James Vander Weide and Dr. Randall Billingsley. Those studies purport to demonstrate that the ILEC cost of capital today far exceeds the 11.25 percent authorized level. The ILEC parties used the Reply Comments to reiterate their earlier themes that the common equity ratio today is far higher than in 1990;[2] business risk in local exchange (and interstate access service) has increased; telecommunications infrastructure development will be impaired by a lower rate of return; and the current LFAM should remain intact. GSA, AT&T and MCI WorldCom filed Reply Comments challenging the ILEC assertions that capital costs associated with interstate access have not declined. Specifically, AT&T submitted a detailed study demonstrating that the current ILEC cost of capital is well below 11.25 percent.[3]

MCI WorldCom's Reply Comments argued that the ILEC policy argument concerning the need to promote infrastructure development and an efficient allocation of resources is both misguided and one-sided. The central problem with interstate access

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[2] The present authorized return of 11.25 percent was established by this Commission in 1990 in CC Docket 89-624.

[3] The AT&T study was prepared by Drs. Bradford Cornell and John Hirshleifer.

service is that the combination of monopoly control and regulatory policy produces a pricing structure far above economic cost. The decline in the cost of capital since 1990 provides at least a modest opportunity to mitigate this pricing distortion, and we urge the Commission to take advantage of this opportunity, which has been created by a favorable capital cost environment. Doing so will serve to enhance economic efficiency, resource allocation and infrastructure development by those telecommunications companies that must purchase interstate access service. Reducing rate of return in response to the clear and convincing decline in capital costs is rational regulation and will benefit consumers. It is not punitive, nor will it discourage economically sound network investment.

Our March 16 Reply Comments emphasized that the general and anecdotal arguments of the ILECs concerning increased "business risk" fail to support their assertions that no significant decline in capital costs has occurred. Only a properly performed cost of capital study using current marketplace data can make that determination. For that reason, MCI WorldCom urged that the anecdotal risk discussion be set aside and the Commission proceed with a cost of capital study. The ILECs have responded in their Reply Comments by sponsoring two cost of capital studies and criticizing the cost of capital evidence of the non-ILEC parties (i.e., GSA and MCI WorldCom). In presenting these studies, the ILEC parties argue that this Commission should radically change its method for determining both cost of equity and capital structure, with one ILEC witness arguing for a common equity ratio of nearly 90 percent. This Rebuttal filing therefore focuses primarily on the technical cost of capital evidence

submitted on March 16. It also discusses the ILEC objections to MCI WorldCom's proposed modification to the LFAM.

II. RESULTS OF THE ILEC COST OF CAPITAL STUDIES IGNORE CHANGES IN ECONOMIC FUNDAMENTALS

The MCI WorldCom Reply Comments, filed on March 1999, documented the clear and compelling decline in market capital costs which have occurred since 1990. The decline is attributable to observable underlying economic fundamentals including the virtual disappearance of inflation (and, consequently, inflationary expectations), rapid increases in productivity, low worldwide commodity prices and the elimination of the enormous federal deficits of a decade ago. These economic fundamentals are obvious and require no further elaboration here.

Yet, incredibly, the ILEC parties ask the Commission to believe that the telephone companies are exempt from these fundamental economic forces.[4] They continue to argue that business risk has increased to such an extent as to fully offset the capital cost decline which the rest of the U.S. economy enjoys. In fact, ILEC experts Dr. Vander Weide and Dr. Billingsley are not content merely to argue that telephone companies have not participated in the economy-wide cost of capital decline. They argue that telephone cost of capital has sharply increased since 1990. Dr. Vander Weide finds a cost of capital of

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[4] Dr. Avera, submitting testimony attached to the Reply Comments of the Local Exchange Carriers Associations, attempts to deny that soaring stock prices for the Regional Bell Operating Companies signal a cost of capital decline, arguing that economists "sometimes find capital markets inscrutable." (Avera at page 3.) If capital markets truly are "inscrutable," the cost of capital is unknowable, and there is no useful purpose in conducting a proceeding to represcribe rate of return. Given his market agnosticism, it should not be surprising that Dr. Avera has not even attempted to estimate the cost of capital.

12.7 to 13.2 percent, while Dr. Billingsley finds a range of 13.95 to 14.15 percent -- a nearly 25 percent increase over the 11.25 percent figure approved by this Commission in 1990.

These implausible cost of capital findings of Drs. Vander Weide and Billingsley have little to do with any alleged increase in business risk or capital structure targets. Rather, they reflect an attempt by the ILECs to induce this Commission to adopt new and flawed cost of capital methodologies. As our comments demonstrated, there is no reason to abandon the classic Discounted Cash Flow (DCF) model, applied to a Regional Bell Operating Company (RBOC) proxy group, as previously used by this Commission. The ILEC criticisms of this methodology are incorrect and without merit. The new methodologies promoted by the ILEC Reply Comments produce implausibly high cost of capital estimates and counterintuitive results.[5]

The second reason advanced by the ILEC for the cost of capital increase is the need to finance investment more heavily with common equity. Once again, this has nothing to do with the underlying changes in capital costs which may or may not have occurred, but rather is an attempt to change capital structure methodologies. In fact, there is no evidence that telephone companies are relying more heavily on equity financing than in the past. The market-based approach attempts to use soaring stock market valuations

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[5] Cost of capital evidence introduced in Reply Comments by AT&T provides one important insight. The AT&T witnesses, Drs. Cornell and Hirshleifer, point out that five-year consensus earnings growth rates, such as those published by IBES, may not be sustainable in the long run. Therefore, they assume that after five years, the earnings growth rate gradually trends toward convergence with the growth rate of the U.S. economy. This observation has important implications for evaluating the ILEC studies, discussed further in Section III.B, infra.

as the basis for increasing (or avoiding a decrease in) the authorized rate of return. This Commission should base its capital structure on the ARMIS balance sheet values, as proposed in the Notice. This reflects the manner in which the local exchange telephone industry finances investment in plant and equipment, while ensuring that the ILECs will retain their strong bond ratings.

III. ILEC PROPOSALS TO EMPLOY NEW METHODOLOGIES SHOULD NOT BE ADOPTED

The Reply Comments of the ILEC parties seek to demonstrate, contrary to objective evidence and common sense, that the cost of capital associated with the provision of interstate access service today is greater than it was in 1990 due to heightened business risk. They further claim that a much more expensive capital structure (i.e., a larger equity component) is needed to offset that increased risk. In reality, the ILECs are simply proposing that this Commission abandon its current methodology, including the methods suggested in the Notice, in favor of new methods designed to produce a higher result. If it were true that the ILEC cost of capital has actually risen (or not fallen) since 1990, then the ILEC witnesses should be able to demonstrate this easily using the same (or similar) methods used by this Commission in its 1990 determination. The ILEC parties have not even attempted to do so.

A. The So-Called Market-Based Capital Structure is Improper for Regulatory Purposes

The ILEC Reply Comments reiterate the proposal to abandon balance sheet values in favor of market data to establish capital structure ratios. The ILEC proposals range from a common equity ratio of 75 percent (Dr. Vander Weide's lower bound) to 88

percent (Dr. Billingsley's value). It is notable that the ILEC parties have not been able to cite a single instance of a regulatory agency at any level of government that has adopted this approach to capital structure. Indeed the Commission has already rejected this approach to setting capital market ratios when it set the currently authorized rate of return in 1990.[6] The ILECs have provided no justification for the Commission to reverse this previous rejection.

The disparity between the balance sheet and market value capital structure has emerged due to soaring stock price valuations for the RBOC common stock. These high market valuations are due to a combination of the impressive profitability of the RBOCs (see MCI WorldCom's Reply Comments, pages 8-9) and declining capital costs. The fact is that RBOC stocks continue to be interest rate sensitive, i.e., their prices rise as interest rates fall. Thus, it is ironic that declines in capital costs (e.g., lower interest rates) are a large part of the reason that the ILECs now claim that their cost of capital has increased or at least not fallen. The chain of illogic, simply put, is that falling capital costs increase stock prices, which in turn means a higher equity to debt ratio, and thus a higher cost of capital for ILECs!

More importantly, the proposed market-based capital structure has no place in setting rates for regulated companies. The intent of rate of return regulation is to provide the regulated company with the opportunity to earn the fair return on equity established by

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[6] See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, 5 FCC Rcd 7507, at paras. 115-7.

the regulator. The balance sheet-based capital structure is consistent with that objective, but the market-based capital structure will not be, if the two methods diverge.

We demonstrate this principle with a numerical example in Appendix A. This example shows that if a 12 percent return on equity is awarded, and a balance sheet capital structure is employed (50/50 in this example), the regulated company should expect to earn a return on equity of 12 percent. However, if rates instead are set assuming an 80 percent equity ratio -- as proposed by the ILECs -- the expected earned return on equity exceeds 16 percent. This clearly would be an excessive return reward and contrary to the intent of the regulator. This simple example illustrates why regulators do not normally employ market value capital structures.

ILEC witnesses seek to criticize the proposal in the Notice to employ ARMIS balance sheet capital structures on the grounds that those actual values have been distorted by accounting write-offs.[7] This criticism is misplaced for several reasons. First, the ARMIS balance sheet values are based upon this Commission's own accounting rules and therefore are <u>not</u> distorted by the write-offs described by ILEC witnesses. These witnesses are confusing the balance sheet values based on financial accounting reported in the Securities and Exchange Commission (SEC) filings, which reflect the abandonment of SFAS 71 accounting, with the ARMIS filings which do not. If the ILEC witnesses had compared the ILEC SEC balance sheets for year-end 1997 with the equity balances in Appendix B of the Notice, they would have realized their error.

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[7] See Avera at pp. 6-7 and Vander Weide at pp 9-10.

Moreover, even if some write-offs to equity are incorrectly included in ARMIS data, such write-offs are simply a fact of life. Management determines the capital structure policy for each company and has the ability to use retained earnings to achieve whatever balance sheet target is selected. What is undeniable is that the balance sheet equity values are the result of deliberate decisions by ILEC management concerning how investment and operations are to be financed.

MCI WorldCom believes that the balance sheet-based capital structure proposed in the Notice is appropriate both for the rate-of-return regulated ILECs, as well as for establishing the incremental cost of capital associated with interstate access service. As demonstrated in our March 16 Reply Comments, investor service organizations frequently refer to balance sheet capital structures. More importantly, bond rating agencies evaluate credit worthiness using balance sheet ratios. The rating agencies find that the current average ILEC capital structure is consistent with single A or double A bond ratings. Appendix B lists bond ratings for the major ILECs, comparing current bond ratings with those in early 1990. As this table demonstrates, there has been little change.

The current ARMIS capital structure of 43 percent debt/57 percent equity is a reasonable mix of capital for financing network investments, and should be adopted in this proceeding. The proposed 20 percent debt/80 percent equity is overly expensive and inconsistent with the manner in which ILEC plant and equipment is actually financed.

B. The ILEC Studies Fail to Properly Measure the Cost of Equity

The ILEC parties sponsor several cost of equity studies prepared by Drs. Vander Weide and Billingsley which purport to demonstrate that the ILEC cost of equity has risen

substantially since 1990. In this Commission's 1990 represcription, the RBOC cost of equity capital was determined to be 12.2 percent on a "bare bones" basis, or about 13.2 percent after factoring in certain adders. Drs. Vander Weide and Billingsley find a dramatically increased cost of equity, despite their imputation of a much richer capital structure.[8] Both witnesses find the ILEC cost of equity to be about 15 percent at the present time.

It is clear from reviewing these studies that the results do not signal an increased cost of capital, but are merely the result of a change in cost of equity estimation methodology from that previously used by this Commission. Had these same methodologies been employed in 1990, it is likely that a much higher cost of equity would have been obtained at that time.

Dr. Vander Weide estimates the cost of equity by applying the DCF model to the Standard & Poor's Industrials,[9] arguing that this group provides the best risk proxy for interstate access service. His study relies upon the IBES "consensus" long run earnings growth rates as the proxy for the growth rate component in the model. His study estimates a cost of equity for this group of 14.77 percent.

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[8] All else equal, increasing the use of equity relative to debt should lower a company's cost of equity, because it reduces the required payments to debt.

[9] Dr. Vander Weide restricts his group to those industrials with a reported stock price, a positive growth rate, at least three analysts providing earnings projections and common stock outstanding. In addition, he eliminates from his group those companies in the highest and lowest quartiles of DCF results. See page 34 of Vander Weide Affidavit.

A central feature of Dr. Vander Weide's study is his assertion, without supporting analysis, that the S&P Industrials are a reasonable risk proxy for telephone interstate access service. His 148 proxy industrial companies are listed on his Schedule 5. We have compiled summary risk indicators for each of these companies from the Value Line Investment Survey (February 28, 1999). Of the 148 listed companies, more than half (76) have Safety Ratings of "3" or "4." (A rating of "3" is considered "average.") By comparison, all of the RBOCs have Safety Ratings of "1" (highest) or "2." We also have compiled beta statistics for 144 of the 148 companies. Nearly half of the betas (67) are reported to be 1.00 or higher, whereas all RBOC betas are below 1.0, indicating below average risk. Clearly, Dr. Vander Weide's assertion that the S&P Industrials are comparable in risk to ILECs, and interstate access service in particular, is not supportable by the objective evidence.

The analysis of AT&T provides further reason for doubting the validity of this study. While Dr. Vander Weide does not report the average earnings growth rate from his study, it would appear to be approximately 12 or 13 percent. As AT&T points out, although such a growth rate may be expected to occur for a period of several years, it is not sustainable over the very long run, as Dr. Vander Weide's study assumes. The earnings growth rates in Dr. Vander Weide's study are two to three times as rapid as plausible long-term growth rates for the U.S. economy.

U.S. corporate profits are approximately $800 billion out of an economy of nearly $8.5 trillion, i.e., slightly less than 10 percent of total U.S. Gross Domestic Product

(GDP).[10] If we assume corporate profits increase by 12 percent per year and nominal GDP increases by 5.5 percent per year, after 20 years corporate profits would become about one-third of GDP. It simply is not reasonable to expect corporate profits' share of national income will more than triple in 20 years. For this reason, AT&T assumes that earnings growth rates eventually will taper off to converge with the overall GDP growth rate.[11]

Dr. Billingsley's evidence is even more troubling than that of Dr. Vander Weide. This is best illustrated by his DCF results for the S&P 500 (a broad measure of the stock market) which he presents in Exhibit No. RSB-8. Using an application similar to Dr. Vander Weide, he obtains an S&P 500 cost of equity in 1999 of a breathtaking 17.0 percent, or more than triple today's return on long-term Treasury bonds. What is even more remarkable is his assertion that the cost of equity for the S&P 500 today is even greater than in 1990 when it averaged about 15.5 percent. (See pp. 2-3 of that exhibit.) This sharp increase in the overall stock market cost of equity took place despite the virtual disappearance of inflation and sharp interest rate declines characterizing today's capital markets.

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10 Economic Report of the President, 1999, pages 326 and 431.

11 This is theoretically a problem with applying the IBES growth rates to the RBOCs as well. However, in the case of the RBOCs, the consensus five-year growth rates are on the order of about 8 percent, not 12 to 13 percent. Hence, for these companies the divergence from the potential growth rate for the U.S. economy is much smaller. Quite apart from considerations of risk comparability, this is a further reason for continuing to use the RBOCs as the DCF proxy group for interstate access service.

Dr. Billingsley attributes this inexplicable cost of equity increase to an increase in the "risk" premium. This assertion is troubling because so many economists and observers of financial markets have concluded precisely the opposite, i.e., that equity risk premia in recent years have fallen.[12] For example, the decline in the equity risk premium is discussed in a recent article in Business Week:

> The risk premium is the difference between the risk-free interest rate, usually the return on U.S. Treasury bills, and the return on a diversified stock portfolio. Over more than 70 years, the return to stocks averaged 11.2 percent, and T-bills, just 3.8 percent. The difference between the two returns, 7.4 percent, is the risk premium ... Most market watchers believe that in recent years, the premium has fallen to somewhere between 3 percent and 4 percent because of lower inflation and a long business upswing that makes corporate earnings less variable.[13]

Dr. Billingsley's estimate of a 17.0 percent stock market cost of equity and his assertion of a sharp increase in the equity risk premium over historic levels are not credible. The ILEC cost of equity proposals must be rejected.

IV. ILEC CRITICISMS OF THE CLASSIC DCF ARE INCORRECT

The ILEC parties criticize the application of the "Classic DCF" model as proposed by GSA, MCI WorldCom and this Commission's Notice. Specific criticisms include:

- the use of the RBOCs as a proxy group for interstate access service;
- the use of the annual rather than quarterly model;
- the "half year" versus full year adjustment to dividend yield;

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12 See AT&T Reply Comments, page 13.

13 "The Market: Too High? Too Low?", Business Week, April 5, 1999, page 93, Joseph Weber and Jeffrey Laderman.

- the need for market weighting of the proxy group; and
- the need for a flotation expense adjustment.

In addition, Dr. Billingsley refers to MCI WorldCom's DCF evidence, based on a 1998 study, as being stale and therefore of little value in this proceeding.

MCI WorldCom responded to some of these criticisms in our March 16 Reply Comments and the full discussion need not be repeated here. The need for a flotation expense adjustment is unsupported because the ILECs cannot even document ever having incurred such expenses, nor do they even suggest they will incur such expenses prospectively. The alleged flotation expenses simply do not exist. MCI WorldCom also explained that the quarterly compounding DCF proposed by the ILECs is improper because the companies receive their rate of return dollars throughout the year. This point was also expressed succinctly in the Reply Comments of AT&T[14] (page 11) and GSA (page 5). AS MCI WorldCom has previously noted in this proceeding, use of the quarterly compounding DCF model to set an authorized rate of return has also been rejected by the Federal Energy Regulatory Commission (FERC) for precisely this reason.[15]

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[14] As AT&T correctly notes:

> Thus, the effective rate that the telephone companies will receive is the Commission's allowed rate compounded monthly. If the Commission used a quarterly compounding DCF model, incumbents would get an effective rate compounded quarterly (as allowed) and monthly (as actually received).

[15] See MCI WorldCom's Reply at 20, fn 19.

A. The RBOCs Are An Appropriate Proxy Group

The ILECs, through Dr. Vander Weide, challenge the continued use of the RBOCs as a DCF proxy group. (Affidavit, page 13) He argues that the DCF model, in order to be validly applied, requires that the proxy companies exhibit a high degree of stability. The RBOCs allegedly violate this assumption due to merger and acquisition activity, changing technology, regulatory restructuring and even changes in financial practices. He argues that if the DCF model is to be applied (and he does favor the use of that model), the RBOCs must be abandoned as a proxy group in favor of a broader group of industrials.

Dr. Vander Weide's assertion that the use of the RBOCs as a proxy group violates the assumptions of the DCF model is flatly wrong. The model does not make the stability assumptions which he identifies. In fact, if it did, the DCF model could almost never be used because few firms could ever satisfy Dr. Vander Weide's insistence on stability. Mergers and acquisitions, technological change, new regulations, changing financial practices are a fact of life in almost every industry. If anything, his "stability criterion" argues strongly for the use of the RBOCs as a proxy group, as demonstrated in MCI WorldCom's Reply Comments. As those Comments demonstrate, the RBOC earnings and return on equity have exhibited remarkable stability.

The truly puzzling aspect of Dr. Vander Weide's argument over the stability criterion is why he believes it supports the use of the S&P Industrials as the appropriate proxy. The vast majority of these companies are subject to the same types of industry dynamics (if not more so) that he identifies as affecting the telephone companies. Thus,

even if the DCF model required the stability assumption that Dr. Vander Weide claims it does, the use of the S&P industrials in place of using the RBOCs would not meet that requirement.

B. There is no Need to Employ Market Weighting of the Proxy Companies

Dr. Vander Weide criticizes GSA for failing to apply market weights to the individual RBOCs in its DCF study. This criticism is incorrect and loses sight of why multi-company proxy groups are used by analysts. Multi-company proxy groups are used because there is "noise" or random movements in stock price data. The averaging associated with using a proxy group helps to smooth out those random errors. Assigning market weights to the individual RBOCs does nothing to eliminate noise in the data, nor does it make the results more representative of the overall interstate access service industry. The market weighting of the individual RBOCs, which may reflect a variety of factors irrelevant to interstate access (e.g., unregulated or competitive operations) does nothing to improve the cost of capital estimate. If the Commission believes some weighting is appropriate for the RBOC group, we would suggest using a measure of relative size more closely tied to the companies' access business, such as net telephone plant balance, rather than market capitalization. However, such weightings merely add computational complexity without improving the accuracy of the estimate.

C. The "Half Year" Adjustment to the Dividend Yield is Correct

The "Classic DCF" formula employs a "0.5 g" adjustment to the current dividend yield to obtain a forward-looking adjusted yield. That is, the dividend component of the

DCF model requires the use of the dividend to be paid out over the next year. This is correctly calculated as the current dividend increased by one-half year of expected growth. It is our experience that the "0.5 g" adjustment is widely accepted in typical DCF applications.[16] The half-year convention is the correct adjustment because the point in time during the year when a Company implements its dividend increase is unknown. Thus, the half-year adjustment produces the correct "expected value," equivalent to assuming that the increase occurs at mid-year.

Despite the widespread acceptance of the half-year growth convention, Dr. Billingsley insists that the full year method is "generally accepted." (Affidavit, page 36) Not only is his "generally accepted" characterization unsupported and incorrect, he provides no clear or convincing explanation why the full-year adjustment is theoretically appropriate.

D. The ILEC's Contention that MCI WorldCom DCF Evidence is Stale Has No Merit

Dr. Billingsley criticizes MCI WorldCom for citing in its January 19, 1999 comments DCF evidence it has submitted to the FCC in this and other dockets. (Affidavit, pp. 39-40) His complaint that such evidence is unduly out of date has no merit. MCI WorldCom's most recent study, which applied the classic DCF model to the RBOC proxy group, was filed in October 1998 using market data for the second and third quarters of 1998. Far from being stale, a 1998 study is generally representative of capital cost conditions today.

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[16] For example, the FERC has consistently employed this adjustment factor in its benchmark DCF model for electric utilities.

The ILEC concern over data timeliness, however, is misplaced. MCI WorldCom cited such evidence only as a general indication and illustration of how much capital costs have fallen since 1990. We expect and fully support an updated DCF study by this Commission which would employ the very latest market data, preferably averaged over a period of several months.

V. MCI WORLDCOM'S PROPOSED LFAM TRIGGER FORMULA IS NOT CONFISCATORY

In its initial comments, MCI WorldCom proposed that the LFAM be eliminated, because complete elimination of the LFAM would confront the ILECs with a commensurately unlimited downside risk to match the infinite upside potential that they now enjoy under the Commission's price cap plan. If the LFAM is not eliminated, MCI WorldCom advocated, then the rate of return at which the LFAM is triggered must be continually adjusted to reflect the fact that the price cap ILECs' generally earn above the target rate of return. Since in practice low earnings by an ILEC in one year are typically offset by above-average earnings in the following year(s), the current LFAM merely places a floor under ILEC earnings without being necessary to protect against continually low earnings.

The Local Exchange Carriers Associations oppose MCI WorldCom's proposed adjustment to the LFAM trigger, on the grounds that it would lead to recapture of all earnings above the prescribed rate of return.[17] This is not true. Those ILECs that earned above the authorized rate of return would retain their earnings. The formula merely

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[17] See Joint Responsive Case and Reply Comments of Local Exchange Carrier Associations at 13.

recognizes the fact that an ILEC that has low earnings in any one year may have achieved above average earnings in prior years, and thus need not have its rate of return guaranteed in each year in order to prevent confiscation.

Similarly, Bell Atlantic argues that adjusting the LFAM trigger as MCI WorldCom proposes would constitute retroactive ratemaking, because it bases the LFAM trigger, and thus ILEC rates, on earnings in the prior years. However, adjusting the LFAM each year to reflect the prior years' earnings is no more retroactive ratemaking than is the use of the LFAM itself.

Finally, Bell Atlantic appears to have misunderstood MCI WorldCom's proposal to calculate the LFAM trigger on industry-wide earnings.[18] MCI WorldCom proposed that the trigger rate of return would be based on industry-wide results, but that each ILEC would compare its own, not the industry's, earnings to that revised trigger in computing its LFAM exogenous adjustment. Thus, in the unlikely event that any ILEC's earnings fell below the trigger as computed using MCI WorldCom's proposed formula, that ILEC would be able to adjust its price cap indexes upwards by the amount necessary to allow them to earn that trigger level.

VI. CONCLUSION

The Reply Comments of the ILECs seek to convince the Commission that the cost of capital for telephone companies has increased, when all objective evidence demonstrates the contrary. The ILECs' claimed increase is merely the result of improperly performed DCF studies and the use of a capital structure containing excessive equity. As

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[18] See Bell Atlantic at 8.

demonstrated in our initial Comments, the asserted 80 percent equity ratio is not needed to obtain strong bond ratings from credit rating agencies, and if used for ratemaking, will result in excessive regulatory earnings.

One of the main bones of contention in the DCF studies is whether the RBOCs represent a reasonable proxy group for measuring the cost of equity for interstate access service. The ILECs have no convincing argument for substituting a broad group of industrial companies, which have little or no telephone operations, for the RBOCs, whose assets are predominantly devoted to local exchange service. The cost of equity results obtained using the industrial proxy groups (about 15 percent) is implausibly high.

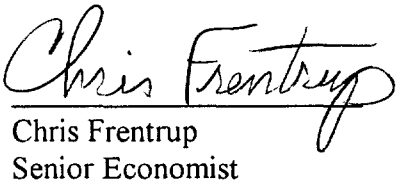
MCI WorldCom continues to support a represcription of rate of return in this proceeding. Capital structure should be based upon the use of ARMIS balance sheet data, as proposed in the Notice, and cost of equity should be computed using the classic DCF applied to the RBOC proxy group. For the reasons expressed in these Comments and

AT&T's Reply Comments, this will provide a conservatively high estimate of the cost of capital associated with interstate access service.

Finally, MCI WorldCom reiterates its position that if the LFAM is retained for the price cap companies, the return benchmark that triggers the LFAM must be lowered to reflect the rate of return represcription in this proceeding.

Respectfully submitted,

MCI WorldCom, Inc.



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April 8, 1999

APPENDIX A
ILLUSTRATION OF EARNINGS EFFECT OF ALTERNATIVE CAPITAL STRUCTURES FOR REGULATORY PURPOSES

This Appendix provides a computational example of how alternative capital structures for regulatory purposes affect the earnings of the regulated company. This example assumes that a utility has a balance sheet capital structure of 50 percent debt/50 percent equity, but the regulator sets the authorized rate of return based upon an assumed 20 percent debt/80 percent equity capital structure. The example demonstrates that this treatment will provide the regulated company with a return on equity far higher than intended. The calculations first demonstrate the return on equity using the conventional capital structure based on actual balance sheet values. The second set of calculations shows the effect of using a hypothetical 20/80 capital structure.

The calculations assume:

(1) Total net plant (i.e., rate base): $1.0 billion

(2) Total debt: $500 million

(3) Book common equity: $500 million

(4) Debt cost rate: 8.0%

(5) Cost of equity: 12.0%

(6) Income tax rate: 35%

(7) Capitalization = Rate Base

A. Earnings Using Conventional Capital Structure

Using the conventional balance sheet capital structure, authorized rate of return would be:

Capital Type	% of Total	Cost Rate	Weighted Cost	Pre-Tax Weighted Cost
Debt	50.0%	8.0%	4.00%	4.00%
Common Equity	50.0	12.0	6.00	9.23
Total	100.0%	--	10.0%	13.23%

The authorized rate of return is 10.0 percent, or 13.23 percent when grossed up for income taxes on the common equity component.

Ratemaking provides the Company a total return plus associated income taxes of $132.3 million, i.e., $1.0 billion x 13.23 percent. In order to compute net earnings, it is necessary to subtract interest expense and income taxes. Interest expense is 8 percent x $500 million = $40 million. Income taxes = ($132.3 million - $40 million) x 35 percent = $32.3 million. Thus, net earnings = $132.3 million - $40 million - $32.3 million = $60 million. The Company's earned return on equity becomes $60 million/$500 million = 12.0 percent, which is the intended result.

This example demonstrates that using the actual balance sheet capital structure will provide the regulated utility with an earned rate of return on equity equal to the authorized return on equity.

B. Earnings Using a Hypothetical Capital Structure of 20/80

In this alternative, the authorized rate of return is calculated using a 20 percent debt/80 percent equity capital structure.

Capital Type	% of Total	Cost Rate	Weighted Cost	Pre-Tax Weighted Cost
Debt	20.0%	8.0%	1.60%	1.60%
Common Equity	80.0	12.0	9.60	14.77
Total	100.0%	--	11.20%	16.37%

The authorized return is 11.20 percent, or 16.37 percent grossed up for income taxes. The total authorized return plus associated income taxes is $1.0 billion x 16.37 percent = $163.7 million.

As before, the return revenue can be converted to net earnings for common by subtracting interest expense ($40 million) and income taxes. The latter is computed as ($163.7 - $40) x 35 percent = $43.3 million. Thus, net earnings for common becomes: $163.7 million - $40 million - $43.3 million = $80.4 million. Given the common equity balance of $500 million, the earned return on equity becomes $80.4/$500 = 16.08 percent. Thus, even if the regulator awards the regulated company a return on equity of 12 percent, the use of the 20/80 capital structure in place of balance sheet values provides an earned return on equity of about 16 percent, far in excess of what was intended.

APPENDIX B

BOND RATINGS COMPARISON FOR THE BELL LECS, 1990 VERSUS 1999[1]

	Company[2]	1990	1999
(1)	Illinois Bell	Aaa	Aaa
(2)	Indiana Bell	Aaa	Aa1
(3)	Michigan Bell	Aa1	Aa1
(4)	Ohio Bell	Aaa	Aa1
(5)	Wisconsin Bell	Aaa	Aa1
(6)	New Jersey Bell	Aaa	Aa2
(7)	Bell of PA	Aa1	Aa2
(8)	Diamond State	Aaa	Aa2
(9)	C&P MD	Aa3	Aa2
(10)	C&P VA	Aaa	Aa2
(11)	C&P D.C.	Aa3	Aa2
(12)	C&P WVA	Aa3	Aa2
(13)	Southern Bell	Aaa	Aaa
(14)	South Central Bell	Aaa	Aaa
(15)	New York Telephone	A1	A1
(16)	New England Tel.	Aa1	Aa2
(17)	Pacific Tel.	Aa3	Aa1
(18)	Nevada Bell	NA	NA
(19)	Southwestern Bell	Aa3	Aa3
(20)	Mountain States	Aa3	A2
(21)	Northwestern Bell	Aa3	A2
(22)	Pacific Northwest Bell	Aa3	A2

[1] Ratings are the highest indicated for a company's senior debt.
Source: Moody's Bond Record, March 1990 and March 1999 issues.

[2] Based on Company's name as of 1990.

STATEMENT OF VERIFICATION

I have read the foregoing and, to the best of my knowledge, information, and belief, there is good ground to support it, and it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on April 8, 1999.

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CERTIFICATE OF SERVICE

I, Carolyn McTaw, do hereby certify that on this 8th day of April 1999, I caused a copy of the foregoing Rebuttal Submission of MCI WorldCom, Inc. to be served upon each of the parties listed on the attached Service List by U.S. First Class mail, postage prepaid.

Carolyn McTaw

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